Treasury / Trust Portofolio

Investment Policy

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Washington State Treasurer

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Office of the Washington State Treasurer

TREASURY / TRUST PORTFOLIO

INVESTMENT POLICY

I. Delegation of Authority

The State Treasurer is an executive officer of the state established by the Constitution of the State of Washington (Article III, Section 1), and "will perform such duties as will be prescribed by law" (Article III, Section 19).

As prescribed by the Revised Code of Washington, "Whenever there is in any fund or in cash balances in the state treasury more than sufficient to meet the current expenditures properly payable therefrom, the state treasurer may invest or reinvest such portion of such funds or balances as the State Treasurer deems expedient." (RCW 43.84.080)

To "ensure effective cash management of public funds" (RCW 43.08.015), the State Treasurer may designate investment officers who will have the authority to perform the duties of the State Treasurer. A list of individuals authorized to conduct trades for the portfolio will be found in Appendix I of this policy, which will be modified, as necessary, to reflect personnel changes.

II. Identification of Funds

This policy applies to the investment of all Treasury and Trust Funds managed by the State Treasurer, with the following exceptions:

- the Local Government Investment Pool, which is governed by separate statute (RCW 43.250) and by separate policy;
- the Time Certificate of Deposit and Linked Deposit programs, which are governed by separate statute (RCW 43.86A);
- funds held by the Department of Labor and Industries as trustee for the U.S. Department of Energy, which are governed by agreement between the Department of Labor and Industries and the U.S. Department of Energy.

III. Objectives

Safety, liquidity and yield are the traditional priorities of treasury investment management. Modern portfolio theory has clarified their relationship, and this policy recognizes that. The traditional priorities are incorporated into a single overall objective.

The overall objective of the State Treasurer's investment policy is to construct, from the investments available under section V below, investment portfolios that are *optimal* or *efficient*. An optimal or efficient portfolio is one that provides the greatest *expected* return for a given *expected* level of risk, or the lowest *expected* risk for a given *expected* return. The emphasis on "expected" is to recognize that investment decisions are made under conditions of risk and uncertainty. Neither the *actual* risk nor return of any investment decision is known with certainty at the time the decision is made.

A key tenet of modern portfolio theory is that there is a relationship between the risk of an asset and its expected rate of return. Under the theory, investment earnings in excess of the risk free rate, defined herein as the overnight repurchase rate for U.S. Treasury collateral, are obtainable only by the assumption of risk of some sort. The theory thus makes two of the traditional objectives of treasury investment—safety and return—mutually exclusive, at least to the extent a return greater than the overnight rate for Treasury collateral is desired.

Setting investment objectives using modern portfolio theory therefore involves specifying the level of *expected* risk that may be assumed and leaving the return variable, or specifying the target *expected* return and leaving the level of risk variable, or some combination of the two.

The Treasury/Trust's investments are separated into two main portfolios, primarily to manage liquidity risk. Objectives are set by portfolio as follows:

1) ***The STIF portfolio***. The main objectives of this portfolio are to meet the liquidity needs of the Treasury/Trust, and to manage the temporary cash positions of the core portfolio. All daily cash requirements are to be met by assets in this portfolio. It has an expected risk objective of zero liquidity risk. This is quantified by maintaining a dollar price of $1.00 in the same sense that a Rule 2a-7 money market fund does. The portfolio will be managed using the same general guidelines as the 2a-7 funds, e.g., maximum maturity of 397 days and a maximum weighted average maturity of 90 days. Consistent with that risk objective, the benchmark for the portfolio will be the net yield of the Donoghue Government Only, Institutional Only group of funds. Return/earnings are calculated on an accrued basis.

2) ***The core portfolio***. The core portfolio is comprised of cash that is not reasonably expected to be necessary to meet the short- or intermediate-term liquidity needs of the Treasury/Trust. Accordingly, this cash may be invested further out the yield curve where, over a market cycle, it is expected to provide a higher return than the STIF

portfolio. Return will be paid on an accrual basis. The benchmark of the core portfolio is the total return of the Merrill Lynch Intermediate Term Government Index (1-4.99 years). The core portfolio may have a maximum modified duration of no longer than 3.50 years. A portion of the portfolio may be managed on a total return basis within these guidelines.

IV. Standards of Care

The State Treasurer and authorized investment officers shall perform their investment duties in a manner consistent with this policy and the standard of a prudent investor, in light of the purposes, terms, requirements and other circumstances then prevailing as to the assets entrusted to them.

In investing, they shall exercise reasonable care, skill, diligence, and prudence, considering investments not in isolation, but in the context of the portfolio as a whole and of an overall investment strategy. That strategy should incorporate the risk and return objectives set forth in this policy.

They shall act with undivided loyalty and impartiality; incur only costs which are reasonable in amount and which are appropriate to their investment responsibilities; and they shall seek to minimize costs whenever they deem it prudent to do so.

They shall be relieved of personal responsibility for credit and market risks encountered in the performance of their investment duties, provided they are acting in accordance with this policy and exercising due diligence. Due diligence requires timely reporting of material deviation from expectations and such other actions necessary to control adverse developments as may be possible, taking into consideration both the circumstances then prevailing and the other provisions of this policy.

Given the legal list of authorized investments and other restrictions contained in this policy, they shall be deemed to have met any requirement for diversification so long as they are in compliance with this policy.

In the case of investments made in accordance with statute for objectives other than those specified in III above, such as in the case of the Linked Deposit Program (RCW 43.86A.060) or as otherwise provided in statute, this policy and its standard of care are restricted to the express provisions of the statutes directing such investments.

V. Authorized Dealers and Financial Institutions

The State Treasurer will maintain a list of brokers/dealers and financial institutions authorized to provide investment services to the state. Authorized broker/dealers and financial institutions will be limited to those that meet one or more of the following:

- financial institutions approved by the Washington Public Deposit Protection Commission (RCW 39.58); or,
- primary dealers recognized by the Federal Reserve Bank;
- non-primary dealers qualified under U.S. Securities and Exchange Commission Rule 15C3-1, the Uniform Net Capital rule, and a certified member of the National Association of Securities Dealers.

Each authorized dealer or institution will regularly submit annual reports, including audited financial statements, and other information as determined by the state treasurer.

VI. Eligible Investments

- Eligible investments are only those securities and deposits authorized by statute (RCW 39.58, 39.59, 43.84.080 and 43.250). Eligible investments include:
- obligations of the U.S. government;
- obligations of U.S. government agencies, or of corporations wholly owned by the U.S. government;
- obligations of government sponsored corporations which are or may become eligible as collateral for advances to member banks as determined by the board of governors of the Federal Reserve;
- banker's acceptances purchased on the secondary market rated with the highest short-term credit rating of any two Nationally Recognized Statistical Rating Organizations (NRSROs), at the time of purchase. If the banker's acceptance is rated by more than two NRSROs, it must have the highest rating from all of the organizations;
- commercial paper, provided that the State Treasurer adheres with policies and procedures of the State Investment Board regarding commercial paper (RCW 43.84.080(7));
- certificates of deposit with financial institutions qualified by the Washington Public Deposit Protection Commission;
- Local Government Investment Pool, for proceeds of bonds or other debt obligations, when the investments are made in order to comply with the Internal Revenue Code of 1986, as amended; and,
- obligations of the state of Washington or its political sub-divisions.

VII. Investment Restrictions

To provide for the safety and liquidity of Treasury and Trust Funds, the investment portfolio will be subject to the following restrictions:

- the final maturity of any security will not exceed ten years (to include the current ten-year U.S. Treasury note on a when-issued basis), except securities used as collateral in repurchase agreements when collateralized as per this policy;

- purchase of collateralized mortgage obligations (CMO) requires prior approval from the treasurer or assistant treasurer; CMO securities must pass the Federal Financial Institutions Examination Council (FFIEC) test, or not exceed a volatility rating of V-5 by Fitch Investor Services, or a similar rating of a nationally recognized rating agency; and,
- the allocation to investments subject to high price sensitivity or reduced marketability will not exceed 15% of the daily balance of the portfolio. For the purposes of this policy investments subject to high price sensitivity or reduced marketability will be defined as structured notes, with the exception of generic callable securities, and floating rate notes which may be reasonably expected to reset at or near par on their reset dates. A structured note is a debt security whose cash flow characteristics (coupon rate, redemption amount, or stated maturity) depend on one or more indices and which may have embedded forwards or options. Structured notes whose cash flows can no longer fluctuate would not count against the 15% allocation.

Investments in non-government securities, excluding collateral of repurchase agreements, will not exceed the following percentages of the total daily portfolio size:

Bankers Acceptances	25%
Commercial Paper	25%
Certificates of Deposit*	10%

* Not including Certificates of Deposit purchased in accordance with RCW 43.86A.030.

The aggregate amount for commercial paper and banker's acceptances will not exceed 35% of the portfolio. Additionally, individual issuers of commercial paper or banker's acceptances will be limited to no more than 5% of the portfolio.

Repurchase and reverse repurchase agreements will be subject to the following additional restrictions:

- transactions will be conducted only with primary dealer's, the state's bank of record, or master custodial bank, and under the terms of a written master repurchase agreements;
- repurchase agreements with any single primary dealer or financial institution will not exceed 20% of the portfolio. Repurchase agreements with any single primary dealer or financial institution with a maturity date past the next business day will not exceed 10% of the total portfolio;
- the maximum term of repurchase agreements will be 180 days;
- the share of the portfolio allocated to repurchase agreements with maturities beyond 30 days will not exceed 30% of the total portfolio;
- the maximum term of reverse repurchase agreements will be 180 days and must be matched to anticipated cash flows adequate to liquidate the transaction; and,

- the maximum portion of the portfolio allocated to reverse repurchase agreements will not exceed 30% of the total portfolio.

Securities accepted as collateral for repurchase agreements will be subject to the following additional restrictions:

- Securities delivered as collateral for a repurchase agreement with a maturity date longer than seven days will be priced at least weekly;
- all collateral substitutions will be approved by the Office of the State Treasurer before the existing collateral is released to the broker/dealer;
- collateral for treasury, agency and money market securities will be priced at 102% of market value, plus accrued income;
- collateral for mortgage-backed repurchase agreements with a maturity date longer than seven days will be priced at 105% of market value, plus accrued income;
- collateralized mortgage obligation (CMO) repurchase agreement collateral must pass the Federal Financial Institutions Examination Council (FFIEC) test, or not exceed a volatility rating of V-5 by Fitch Investor Services, or a similar rating of a nationally recognized rating agency; and,
- only securities authorized in statute for the investment of public funds will be accepted as collateral.

Additional operating guidelines will provide details relating to the frequency of collateral pricing, collateral substitutions, and margin calls.

VIII. Professional Services

The State Treasurer may contract for professional services as necessary for the efficient management of investments.

Appointment of Master Custodian

The State Treasurer may select one or more firms to provide the state with master custodial services. Master custodial services will include, but not be limited to:

- executing transactions involving all securities held in custody, including on-line security clearing, settlement of securities on a delivery-versus-payment basis, and settlement of physically-held securities;
- providing regular reports on the activity and value of the securities in custody; and,
- providing for the safekeeping of all documents and financial instruments physically held in custody.

Appointment of Securities Lending Agent

The State Treasurer may select one or more firms to provide securities lending management services. Securities lending services will include, but not be limited to:

- ensuring all loans of coupon-bearing securities are supported by collateral valued at not less than 102% of market value of the securities, including accrued income;
- ensuring all loans of non coupon-bearing securities supported by cash collateral, shall not be valued at less than 102% of market value, but not to exceed par;
- ensuring all loans of non coupon-bearing securities supported by non-cash collateral, shall not be valued at less than 102% of market value;
- ensuring that the investment of cash collateral be only in securities authorized in this policy, and that the restrictions on investments found in sections V and VI of this policy also apply to investments made by a securities lending agent, except that the amount of securities on loan will only count against the limit on reverse repurchase agreements at fiscal year end;
- ensuring that the collateral accepted in a bonds borrowed transaction conforms to the collateral requirements of this policy;
- providing next day liquidity for all securities on loan; and,
- providing monthly accounting, performance, compliance, and management reports.

The services of a master custodian and securities lending agent will be obtained through an evaluation of competitive proposals submitted in response to a regularly issued request for proposals.

Securities purchased by the office are to be held by the master custodian, acting as an independent third party, in its safekeeping or trust department.

Collateral is to be similarly held or held by an independent third party with whom the office has a current master repurchase agreement.

All securities transactions are to be conducted on a delivery-versus-payment (DVP) basis only, and a trade confirm/safekeeping receipt is to be provided to the Office of the State Treasurer.

IX. Internal Controls

The State Treasurer will maintain internal controls to protect against the loss of public funds arising from negligence, theft, or misuse. These controls will include, but not be limited to:

- the use of a master custodian;
- the execution of all securities transactions on a delivery versus payment basis;
- the clear delegation of investment authority; and,
- the separation of duties, such as the separation of transaction authority from record keeping.

An investment policy committee, composed of the assistant treasurer, the deputy treasurer for investments, and authorized investment officers, will regularly review this policy.

Daily compliance reports, as well as monthly performance reports, will be provided to the treasurer and assistant treasurer.

X. External Controls

As prescribed by RCW 43.09.050, the State Auditor will audit the accounts and inspect the books of the State Treasurer to determine the compliance of investment activities with state statutes and this policy.

XI. Reporting

The State Treasurer will prepare regular reports summarizing investment activity of the portfolio.

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Approved by Michael J. Murphy, State Treasurer Date

Effective Date: January 1, 2001

Appendix I

Individuals authorized to conduct trades for the Treasury/Trust portfolio are as follows:

Michael Colleran, Assistant State Treasurer

Douglas D. Extine, Deputy Treasurer

Jill M. Gravatt, Investment Officer

Lisa Hennessy, Investment Officer

Ferdinand Pascual, Investment Officer